DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-20030170
Gross Income Tax
For 1999 through 2001

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Notice of 1999 Proposed Assessment.

Authority: IC 6-8.1-5-2; IC 6-8.1-5-2(a).

Taxpayer argues that the 1999 notice of "Proposed Assessment" was untimely on the ground that taxpayer received the 1999 notice more than three years after the later of the due date for taxpayer's 1999 return and the date on which that return was filed.

II. Rental Company – Gross Income Tax.

Authority: IC 6-2.1-2-2; U-Haul International, Inc. v. Ind. Dept. of State Revenue, 826 N.E.2d 713 (Ind. Tax Ct. 2005); U-Haul Co. of Indiana Inc., et al. v. Ind. Dept. of State Revenue, 784 N.E.2d 1078 (Ind. Tax. Ct. 2002).

Taxpayer maintains that the audit erred in assessing it with gross income tax on the Indiana rental company's share of amounts collected from the public by its Indiana rental dealers.

III. Fleet Owner – Gross Income Tax.

Authority: IC 6-2.1-2-2; IC 6-2.1-2-2(a); IC 6-8.1-3-3; IC 6-8.1-3-3(b); U-Haul International, Inc. v. Ind. Dept. of State Revenue, 826 N.E.2d 713 (Ind. Tax Ct. 2005); U-Haul Co. of Indiana Inc., et al. v. Ind. Dept. of State Revenue, 784 N.E.2d 1078 (Ind. Tax. Ct. 2002); Enterprise Leasing v. Indiana Dept. of Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); 45 IAC 1.1-1-3(a); 45 IAC 1.1-2-10(a); 45 IAC 15-3-2; 45 IAC 15-3-2(d)(2)(C); Tax Policy Directive 9 (Ind. Dept. of Rev. December 1995).

Taxpayer states that the audit erred in treating the fleet owner as subject to gross income tax and assessing the fleet owner for gross income tax.

IV. Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the assessment of the ten percent negligence penalty was illegal and erroneous.

STATEMENT OF FACT

Taxpayer is a company in the business of renting to the public moving equipment such as trucks, trailers, and related materiel.

For the sake of clarity, "taxpayer" in this Letter of Findings refers to the umbrella organization under which the company operates its rental business. Taxpayer is composed of four groups: (1) fleet owners; (2) rental companies; (3) rental dealers; and (4) the international company. The groups are bound together by various contractual relationships.

The fleet owners are corporations, partnerships, or individuals which own and supply the rental equipment to taxpayer. Under the contracts between the fleet owners and the taxpayer, the fleet owners entrust their equipment to taxpayer in exchange for a percentage of the rental received by the rental dealers from the public. The fleet owners earn approximately 35 to 55 percent of gross receipts received from the public.

The rental companies are separate companies that merchandise and supervise the maintenance and repair of the rental equipment. The rental companies contract with the international company; the international company assigns a territory in which the rental company is responsible for establishing rental dealers. The rental companies receive a percentage of the gross income collected by the rental dealers in the rental companies' own territory. The rental companies earn approximately 10 to 30 percent of the gross receipts received from the public.

The rental dealers are the local businesses that rent the moving equipment to the public. Under the rental dealers' contract with the rental companies, the rental dealers make weekly deposits of all the rental income collected from the public. The deposits are made into an account which belongs to the international company. The rental dealers earn approximately 25 to 35 percent of gross receipts received from the public.

The international company provides clearinghouse, accounting, computer, management and various services to taxpayer. After the international company receives the rental amounts from the rental dealers, the international company distributes the contractual shares of that income to the fleet owners, the rental companies, and the rental dealers. As compensation for providing the services, the international company earns service fees from the other members. Unlike the other participants, the international company does not retain a contractually defined percentage of the rental amounts the rental dealers deposit into the account. U-Haul International, Inc. v. Indiana Dept. of State Revenue, 826 N.E.2d 714-15 (Ind. Tax Ct. 2005).

The Department of Revenue (Department) conducted an audit review of taxpayer's 1999, 2000, and 2001 tax returns and business records.

The audit found that one of the rental companies did not report as gross income the rental company's percentage share of the rental income the rental company received from Indiana customers. An adjustment was made to assess gross income tax on that amount.

The audit found that one of the fleet owners did not report as gross income the fleet owner's percentage share of the rental income attributable to the rental of vehicles in Indiana. Therefore, the audit made an adjustment to assess the fleet owner gross income tax on receipts earned from the rental of vehicles in Indiana.

Taxpayer did not agree with the adjustments and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

DISCUSSION

I. Notice of 1999 Proposed Assessment.

The Department's audit resulted in the issuance of notices of "Proposed Assessment." The notices indicated that taxpayer owed additional corporate income tax for 1999, 2000, and 2001.

As a threshold issue, taxpayer argues that the "1999 proposed assessment [is] untimely and invalid." Taxpayer states that it received "the 2000 and 2001 Notices, along with an audit report covering the years 1999, 2000, and 2001 . . . in late February, 2003." However, taxpayer states that it "never received a "notice of Proposed Assessment for 1999 until 2005 . . . ."

IC 6-8.1-5-2 states in part that, "[T]he department may not issue a proposed assessment . . . more than three (3) years after the latest of the date the return is filed, or . . . the due date of the return . . . ." IC 6-8.1-5-2(a). Taxpayer claims that the 1999 proposed assessment is untimely stating that "the time for issuing a proposed assessment to [taxpayer] for 1999 expired on January 15, 2003."

The notices of "Proposed Assessment" for 2000 and 2001 were issued on "1/28/2003" and "1/13/2003 respectively. Taxpayer indicates that these two notices were received together with a copy of the August 1, 2002, audit report in February 2003. Because the 1999 "Proposed Assessment" was not received at the same time, taxpayer – stating that it did not receive the 1999 notice until 2005 – maintains that the 1999 assessment is time-barred pursuant to IC 6-8.1-5-2. However, the 1999 notice plainly indicates that it was issued on "12/23/2002." Accepting taxpayer's assertion that the time for issuing the proposed 1999 expired January 15, 2003, the 1999 notice was timely issued. Although there is nothing in the written record which definitely explains why the 1999 notice was not mailed to taxpayer together with the 2000 and 2001 notices, it is not unreasonable to assume that the 1999 notice was issued earlier in order to assure that the notice was timely.

FINDING

Taxpayer's protest is respectfully denied.

II. **Rental Company** – Gross Income Tax.

Taxpayer states that the Indiana rental company was not subject to gross income tax on money attributable to the rental income received from Indiana customers. Taxpayer states that the rental company had no beneficial interest in this money as determined in U-Haul Co. of Indiana Inc., et al. v. Ind. Dept. of State Revenue (*U-Haul I*), 784 N.E.2d 1078 (Ind. Tax. Ct. 2002).

During the three years at issue, the state's gross income tax was imposed under IC 6-2.1-2-2. The gross income tax is levied upon the receipt of "(1) the entire taxable gross income of a taxpayer who is a resident or domiciliary of Indiana; and (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." Id.

The Department is unable to agree with taxpayer's assertion that the Tax Court determined in *U-Haul I* that the rental company did not have a beneficial interest in the rental income. As explained in U-Haul International, Inc. v. Ind. Dept. of State Revenue (*U-Haul II*), 826 N.E.2d 713 (Ind. Tax Ct. 2005), In *U-Haul II*, the court held that the "rental companies *do* have a beneficial interest in their contractually specified percentage of the rental receipts." Id. at 717 (*Emphasis in original*). "What logically and naturally follows from [*U-Haul I*] is that each member of the U-Haul System has a beneficial interest in its own contractually specified percentage of the rental receipts." Id. The court concluded that the rental companies "[were] subject to gross income tax on that portion of the rental income in which they [had] a beneficial interest." Id. at 718.

The audit correctly assessed the Indiana rental company gross income tax on its contractually specified percentage of the receipts earned from individual rental transactions which occurred in Indiana.

FINDING

Taxpayer's protest is respectfully denied.

III. **Fleet Owner** – Gross Income Tax.

Taxpayer argues that the fleet owner was not subject to gross income tax because the fleet owner did not have any gross income which was "derived from activities or businesses or any other sources" within the meaning of IC 6-2.1-2-2.

In support, taxpayer cites to Enterprise Leasing v. Indiana Dept. of Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002). In that case, the Tax Court found that an out-of-state company did not receive Indiana source income when it rented Indiana-titled cars to its customers; therefore, the rental income was "not subject to Indiana's gross income tax." Id. at 1292.

IC 6-2.1-2-2(a) imposes the gross income tax on the receipt of "the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary or Indiana." However in Enterprise, the Tax Court found

that certain rental income received from Indiana customers was not Indiana source income for gross income tax purposes.

A. Critical Transaction:

In Enterprise, the court found that money received from renting Indiana titled cars was not Indiana source income because it was not the petitioners who decided to register and operate the cars within the state. Enterprise 779 N.E.2d at 1291. Rather, it was the decision of the individual customers to register and operate the cars in Indiana. Id. The petitioners' activities in sending the cars to its customers "did not rise to the level of 'active participation' in the 'ownership, leasing' or rental' of property in Indiana." Id. The court determined that the "critical transaction" that related to the leasing of the cars occurred at the petitioners' out-of-state location. Id. at 1230.

The Department does not find that the decision in Enterprise is dispositive of the question of whether the fleet owner's contractually specified percentage of the receipts earned from individual rental transactions, which occurred in Indiana, is subject to the gross income tax. In Enterprise, the fact that the tangible personal property happened to be located within Indiana was unrelated to the "critical transaction" which formed the basis for the petitioners' income. In taxpayer's situation, the rental income is derived from property located within this state and the "critical transaction[s]" – on which the fleet owner's income is entirely predicated – occurred entirely within the state.

Taxpayer's argument to the contrary, the analysis seems reasonably straightforward. 45 IAC 1.1-1-3(a) states that, "[A] taxpayer may establish a 'business situs' in ways including, but not limited to, the following: (6) Ownership, leasing, rental or other operation of income producing property (real or personal)." Taxpayer receives a contractually specified share of rental receipts attributable to the rental of property to Indiana customers. 45 IAC 1.1-2-10(a) provides that "rental income derived from leasing real or personal property is taxable as a service under section 5 of this rule."

As between the four constituent parties which compromise taxpayer's business system, the "critical transaction" does not arise from the contractual relationship established among those parties. The fleet owner does not earn money because it entered into an agreement with the international company; the fleet owner obtained the income here at issue because the fleet owner's vehicles were rented to Indiana customers by a local Indiana dealer pursuant to transactions which occurred entirely within Indiana. The fleet owner's proportionate share of the Indiana rental income is not an abstraction remote or distinguishable from the fleet owner's vehicles. The fleet owner's share of the Indiana receipts consists of earnings to which the fleet owner is contractually entitled and in which the fleet owner possesses a fixed and determinable beneficial interest. *See U-Haul II*, 826 N.E.2d at 717.

B. Change in Interpretation:

In addition, taxpayer states that the imposition of the gross income tax assessment on the fleet owner's percentage of the rental received from the public represents a change in the Department's interpretation of the gross income tax law prohibited under IC 6-8.1-3-3.

According to taxpayer, because the Department has changed its interpretation from that set out in a 1986 Letter of Findings, the assessment of tax on the gross income received by the fleet owner is barred.

IC 6-8.1-3-3(b) states that "No change in the department's interpretation of a listed tax may take place before the date the change is: (1) adopted in a rule under this section; or (2) published in the Indiana Register under IC 4-22-7-7(a)(5), if IC 4-22-2 does not require the interpretation to be adopted as a rule; if the change would increase a taxpayer's liability for a listed tax."

The 1986 Letter of Findings to which taxpayer refers stated that, "For gross income tax purposes, [fleet owner] cannot be characterized as having taxable instate activity or business contemplated by [IC 6-2.1-2-2(a)(2)]. [Fleet owner] is one step removed from the typical nonresident lessor in that it leases to [taxpayer] which subsequently rents or leases to end customers."

Tax Policy Directive 9 (Ind. Dept. of Rev. December 1995) states that "a departmental ruling will automatically become null and void and no longer of any effect for tax years beginning after December 31 of the sixth (6^{th}) year after the year in which the ruling is issued." In addition, the Directive states that "all rulings issued by the Department prior to January 1, 1990 are hereby declared null and void and of no effect for tax years beginning after December 31, 1995." Under either provision of the 1995 Directive, the 1986 Letter of Findings on which taxpayer relies was "null and void and of no effect" at the time the 2003 audit was conducted.

Nonetheless, the Department is willing to agree that the stance taken in the 1986 Letter of Findings is at variance with the position taken by the Department's 2003 audit and in this most recent Letter of Findings. However, it is self-evident that this Letter of Findings – reflecting the position set out in the 2003 audit – will in due time be published in the Indiana Register under the requirements stipulated under IC 6-8.1-3-3(b).

The more pertinent question is whether the Department's position on the taxability of the fleet owner may be applied retroactively; can the Department's change of position, set out in a 2003 audit and in a Letter of Findings published during 2006, effect the taxability of income received during 1999, 2000, and 2001?

45 IAC 15-3-2 provides in relevant part provides as follows:

> As a general rule, the revocation or modification of a ruling will *not be applied retroactively* with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability was directly involved in such a ruling. Under circumstances where a ruling to a taxpayer is revoked with retroactive effect, the notice to such taxpayer will set forth the grounds upon which the revocation is being made and the extreme circumstance under which revocation is being applied retroactively. This retroactive revocation is decided upon a case-by-case basis taking into account all relevant facts and circumstances. The department may exercise its discretion to retroactively rescind or modify rulings in the following extreme circumstances, which are not all inclusive:

(A) There was a misstatement or omission of material facts.
(B) The facts, as developed after the ruling, were materially different from the facts on which the department based its ruling.
(C) There was a change in the applicable statute, *case law* or regulation.
(D) The taxpayer directly involved in the ruling did not act in good faith.
(*Emphasis Added*)

In U-Haul Co. of Indiana Inc., et al. v. Ind. Dept. of State Revenue (*U-Haul I*), 784 N.E.2d 1078 (Ind. Tax. Ct. 2002) and U-Haul International, Inc. v. Ind. Dept. of State Revenue (*U-Haul II*), 826 N.E.2d 713 (Ind. Tax Ct. 2005), the court disagreed with the Department's position that 100 percent of the petitioner's gross income was subject to gross income tax. *U-Haul I*, 784 N.E.2d at 1084. The court stated that each member of the company had a beneficial interest in its "own contractually specified percentage of the rental receipts" and that the international company was "not contractually entitled to any of the rental receipts." *U-Haul II*, 826 N.E.2d at 717-18.

In the two U-Haul decisions, the court found that the Department had erred in its interpretation of the gross income statutes in regards to taxpayer's corporate income tax liability. Specifically, the court found that the individual component fleets owners, rental companies, and rental dealers were each liable for gross income tax on their contractually defined percentage of the rental receipts and that the international company was not liable for gross income tax on any portion of the rental receipts. Based on the two U-Haul decisions, the Department must conclude that the 2003 audit comports fully with the tax court's earlier decisions and that the 2002 and 2005 decisions constitute "a change in the applicable statute, *case law* or regulation" which justifies a retroactive application of the Department's position as set out in the 2003 audit report and in this superseding Letter of Findings. *See* 45 IAC 15-3-2(d)(2)(C).

FINDING

Taxpayer's protest is respectfully denied.

IV. Negligence Penalty.

Taxpayer argues that there is "no indication in the Audit report of any wrongdoing on the part of [the rental company] or [the fleet owner] which would justify the imposition of the proposed penalty, nor is there any factual support of any kind for the assessment of a penalty."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Given the fact that the Tax Court did not hand down the decision in *U-Haul II*, until May 2005 and the fact that the Department has changed its stance to reflect the court's decisions in both *U-Haul I* and *U-Haul II*, the Department agrees that taxpayer has made a threshold showing that taxpayer exercised reasonable care and prudence in reporting its income as it did during 1999, 2000, and 2001.

FINDING

Taxpayer's protest is sustained.

DK/SP/JM – 061702